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Current issues

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Articles this month:

Revising the DB funding Code

The Pensions Regulator has announced some details of the forthcoming revision of *Code of Practice No. 3: Funding Defined Benefits*.[1] As anticipated, the aim of the exercise will be to clarify the Regulator's expectations, particularly by encouraging trustees to adopt a long-term outlook. The Regulator intends to put forward options for the revised funding framework before re-drafting the Code. It will conduct public consultations at both stages, with the first phase pencilled in for the summer of 2019.

Recap

In its March 2018 White Paper, *Protecting Defined Benefit Pension Schemes*, the Department for Work and Pensions (DWP) said that the Regulator would revise the Code of Practice to clarify how trustees might show that the required prudence has been exercised in the calculation of their scheme's '*technical provisions*' (i.e. liabilities), and how they should judge the appropriateness of recovery plans, as well as requiring them to take a long-term view when setting their statutory funding objective.[2] It also indicated that compliance with the revised Code (or parts of it) would become mandatory.

Funding regime

In a 'blog' published on 9 May 2019, the Regulator says that the long-term objective (LTO) concept will be '*at the heart of*' the revamped Code. The Regulator will set forth some options for a revised funding framework, including suitable LTOs for schemes at different stages in their lifecycles. In the case of closed schemes, there will be suggestions as to how reliance on the employer covenant should dwindle so that a state of low dependency is reached with advanced maturity. Where schemes remain open to accrual, the range of possibilities will seek to ensure that past service benefits are protected, whilst avoiding unnecessary cost increases that might force them to close.

The Regulator will propose options for the ways in which trustees could plan to reach their chosen LTOs, again considering differences in scheme maturity and employer covenant strength. It says that recovery plans should seek to eliminate deficits as quickly as is reasonably affordable, without impeding sustainable growth. It will ask whether stronger employers should, generally, be required to pay down deficits sooner, with a view to providing

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[1] *Protecting DB savers: our expectations are clear* <blog.thepensionsregulator.gov.uk/2019/05/09/protecting-db-savers-our-expectations-are-clear>.
[2] For a more extensive summary of the White Paper, see our Sixty Second News Summary, *Protecting DB pension schemes: White Paper* (March 2018) <www.hymans.co.uk/media/uploads/1803_White_Paper_Protecting_DB_Schemes_60SNS.pdf>.

guidance on acceptable recovery periods for given covenant strengths. The Regulator also promises to test its ideas about the uses of contingent funding solutions, and how to make them a viable prospect for more schemes.

The proposals will include ways for trustees to determine whether the risks in their investment strategies are acceptable, by stress testing, for example.

This initial consultation exercise about the funding framework is being planned for '*this summer*', but the schedule is subject to '*the legislative timetable*'.

Revised Code

Once the Regulator has responses to its proposals for clarifying the funding regime, it will proceed to redraft the Code of Practice. One goal is to offer an off-the-peg way for trustees and employers to show that they have complied with their funding obligations. They will be able, instead, to develop their own, made-to-measure approach, but on the understanding that it comes with a heavier evidential burden and will be more thoroughly investigated by the Regulator.

The draft Code will be published for consultation purposes in 2020, once the Government's legislative intentions are established.

Note that the Regulator's indicative timings are dependent on legislation. Guy Opperman, the pensions minister, has said that the DWP's preparations for a Bill are '*at a great state of readiness*', and indeed that it is the only one that the Department has on the go.[3] However, those plans may be affected by (what else?) Brexit. There has been speculation that, having scaled back the Queen's Speech for the elongated 2017 – 2019 Parliamentary session, the Prime Minister may avoid kicking off a new session with a legislative agenda that she cannot get past MPs.

The Regulator, reviewed

A review of the operations of the Pensions Regulator, conducted for the Department for Work and Pensions (DWP), is generally complimentary, but has made recommendations for improvement.[4] The most notable suggestion is that the DWP should consider endowing the Regulator with some limited rule-making powers.

The review, which takes place roughly every five years, was in this instance led by Jamey Johnson, the Chief Officer of Pension Wise. It notes that the Regulator has grown and taken on more responsibilities over the last decade, so that it '*in many ways no longer resembles the Regulator of the past.*' It also acknowledges the '*intense media and Parliamentary scrutiny*' that the Regulator endured as consequences of the events involving BHS, Carillion and the British Steel Pension Scheme, saying that it '*is making the changes it needs*'. It concludes that the organization is well-run, commending it specifically for the roles that it has played in the introduction of automatic enrolment and improving public sector governance and administration standards. It also thinks that the Regulator is balancing its competing statutory objectives effectively.

That said, it does suggest some changes. The most interesting is perhaps the idea that the DWP could imbue the Regulator with power to make rules in some areas, so that it is not so reliant on the Government and Parliament when the need for action arises, but subject to '*ministerial oversight and industry input*'. This, it is suggested, could allow it to respond more quickly to changing risks, and advance its '*clearer, quicker, tougher*' ambitions. The review report alludes to cases in which schemes were unable to comply with data requirements because '*the regulations ... cannot change at the same pace as the digital world*'.

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[3] Work and Pensions Committee, Oral evidence: *Pension costs and transparency*, 3 April 2019 <data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/work-and-pensions-committee/pension-costs-and-transparency/oral/99411.html>.

[4] *Tailored Review of The Pensions Regulator* <assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/801071/the-pensions-regulator-tailored-review.pdf>.

Amongst the other recommendations were the following:

- the Regulator could usefully provide more support and guidance about Brexit;
- a suggestion that the DWP could loosen the apron strings somewhat as regards budgetary decisions;
- a gap in the Regulator's Board-level expertise, in the areas of organizational and digital transformation, is identified (the report suggests that it could kill two birds with one stone by recruiting someone who would increase the ethnic diversity in the top rank);
- given the emphasis in the Regulator's guidance on compliance with 'key requirements', it should ensure that its Codes of Practice identify the correct minimum standards;
- the Regulator could make more use of data submitted electronically to Her Majesty's Revenue and Customs, as a way of reducing the demands on trustees and employers; and
- as DWP's auto-enrolment programme draws to a close (in November 2019), it would be helpful to the Regulator if its future funding arrangements were settled.

The report says that all of its recommendations have been accepted by the relevant parties.

We are unsure where, specifically, the Regulator might benefit from rule-making powers. The report mentions the details of the information that it requires from schemes. However, the Regulator already has powers to issue scheme returns that require trustees to provide such information as it 'reasonably requires for … the exercise of its functions'.[5] In any case, a move from rule enforcement to rule making would be a significant change, and any such powers ought to be wielded with discretion.

Opinion puts PPF compensation levels in doubt

An Advocate General of the European Court of Justice has urged the Court to reconsider the benchmark that it has developed for the extent of member states' obligation to safeguard employee pension rights in employer insolvency cases.[6] If the ECJ accepts his opinion it could have consequences for the UK's Pension Protection Fund (PPF) and its levy payers.

The ECJ's judgment in the *Hampshire* case, given in September 2018, has already forced a re-appraisal of the PPF's compensation-capping provisions.[7] In it, the ECJ concluded that each employee is entitled to compensation of at least 50 per cent of the value of his or her pension entitlement. The PPF has begun paying increased compensation to those affected by the ruling (although its approach to implementation is being challenged in the UK courts).[8]

The 'at least 50 per cent' yardstick was developed by the ECJ over the course of several judgments, of which *Hampshire* is the latest. In that ruling, and one earlier decision, it alluded to the possibility that a reduction of less than half could still be '*manifestly disproportionate*' in some circumstances. Advocate General Hogan, in a case involving a German insolvency insurance institution, calls for '*a full re-appraisal of the case-law … to date*', observes that '*there is no special magic in the 50%*', and expresses the view that '*the reasoning of the Court in …* [the past] *cannot be supported and should not now be followed*'.

We noted in our report on the Hampshire judgment that the Court had hinted that losses of less than half of the value of a member's expected benefits might still be excessive in some cases. It appears that Advocate General Hogan is trying to use that comment as a lever by which to raise the level of protection to something much closer to 100 per cent. The ECJ need not follow the AG's opinion, but often does so in practice.

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[5] Section 65(4) of the *Pensions Act 2004*.
[6] *Pensions-Sicherungs-Verein VVaG v Günther Bauer* (Case C 168/18).
[7] *Hampshire v Board of the Pension Protection Fund* (Case C-17/17). For a summary of the judgment see *Current Issues* October 2018 <www.hymans.co.uk/news-and-insights/research-and-publications/publication/current-issues-october-2018>.
[8] <www.ppf.co.uk/news/we-begin-implementing-european-court-justice-ruling>.

Ombudsman responds to High Court rebuff

The Pensions Ombudsman has published a factsheet explaining why he believes that he is, contrary to a recent High Court judgment, a '*competent court*'.[9] The issue is relevant to the question of whether trustees can offset past overpayments against future benefit instalments without judicial approval, in some cases.

In *Burgess v BIC UK Ltd*, the Court considered trustees' ability to recoup overpayments from future pension instalments.[10] The judge noted that they are unable to do so until any dispute as to the amount owed is settled by (amongst other possibilities) '*an order of a competent court*'.[11] He did not think that an Ombudsman's determination could itself constitute an order of a competent court, because the Ombudsman is not a court.[12]

The Ombudsman, who was not represented at the hearing, has responded to the ruling, saying that he considers the judge's comments on the subject to be *obiter dicta* (a Latin phrase meaning that the observations were merely incidental to the main ruling) and '*provisional*', having been delivered without the benefit of hearing the full legal arguments. The factsheet lists several points in support of the Ombudsman's conclusion that he *is* a competent court. It notes, for example, that his determinations are final and binding upon the parties to the dispute, subject to appeal on a point of law.

The Court of Appeal's decision on an appeal against the High Court ruling was handed down in May 2019, and is the subject of a separate article in this edition of Current Issues. It did not deal with the High Court judge's opinions on recoupment and whether the Ombudsman is a 'competent court', so some uncertainty remains. It seems that we must wait for the matter to be raised in court again before we can be sure who has the right of it. Trustees might prefer the Ombudsman's view: if the High Court judge is right, they may need to go to the county court (sheriff court in Scotland) before proceeding with recoupment whenever the scheme beneficiary refuses to accept the Ombudsman's decision.

Re-writing history impermissibly

The Court of Appeal has overturned a ruling that improperly introduced pension increases were retrospectively validated by a subsequent trust deed and rules.[13] It was impossible to deduce from the very unusual circumstances of the case any intention on the part of the trustees to exercise the powers that were retrospectively conferred on them.

Facts

The trustees and principal employer of a defined benefit pension scheme decided to introduce limited price indexation for pensions accrued from 6 April 1992. Note that this was before 6 April 1997, when increases to pensions in payment became mandatory. The decision was recorded in the minutes of a trustee meeting, and announced to members; increases were subsequently paid as intended and the scheme funded accordingly. However, the formalities required by the amendment rule that was in force at the time were not observed, and no provision for pre-'97 increases was made in the trust deeds and rules that were adopted thereafter, in 1993 and in 2006.

High Court ruling

The trustees and employer went to court to determine whether provision for pre-'97 increases had ever been validly introduced.[14] By the time the case reached the Court of Appeal it was agreed that the attempt to implement the

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[9] *Recoupment in overpayment cases: the Pensions Ombudsman is a 'competent court'* <www.pensions-ombudsman.org.uk/2019/04/recoupment-in-overpayment-cases-the-pensions-ombudsman-is-a-competent-court>.
[10] [2018] EWHC 785 (Ch).
[11] Section 91(6) of the *Pensions Act 1995*.
[12] For a fuller summary of the April 2018 judgment, see *Current Issues* May 2018 <www.hymans.co.uk/media/uploads/1805_Current_Issues.pdf>.
[13] *BIC UK Limited v Burgess and Others* [2019] EWCA Civ 806.
[14] The impetus for the original decision to grant the increases was a need to reduce the funding surplus that existed at the time, as required under the pre-6 April 2006 tax rules. The scheme now has a material funding deficit, so the precise extent of its liabilities is of pressing concern.

increases in 1992 had been invalid because of the failure to comply with the necessary formalities. However, the 1993 version of the trust deed and rules was, for unconnected reasons, written so as to take effect from 6 August *1990*. Moreover, it gave the trustees powers which, they argued, retrospectively validated the earlier, invalid steps. The employer contested the trustees' argument.

In the High Court, the judge ruled in the trustees' favour, saying that, although a retrospective exercise of the powers in the 1993 deed and rules was '*re-writing history*', it did not do so '*impermissibly*'.[15] The employer appealed.

Court of Appeal judgment

The Court of Appeal overturned the High Court judge's decision, saying that '*the solution which he adopted went a step too far and involved the re-writing of history to an impermissible extent.*' There is '*a clear distinction between having the power to do something, and actually exercising the power.*' In order to achieve the result for which the trustees argued, it would at the very least be necessary to find a common intention on the part of the trustees and the principal employer that the 1993 deed would have the effect of ratifying any amendments that had been invalid when made, but which could have been validly introduced under that deed. However, there was nothing in the 1993 deed to indicate that that was part of its purpose, and indeed the omission of provision for increases to pre-'97 pensions was evidence to the contrary.

The Court of Appeal rejected the suggestion that it is *impossible* to use powers of amendment to remedy an innocent breach of trust: it was aware of no principle of law preventing trustees from exercising such a power to confirm a previous exercise that was invalid because of '*an unwitting failure to comply with the necessary formalities*'. Indeed, '*the ability to take remedial steps of this nature is in principle salutary, and conducive to good trust administration.*' Nevertheless, whilst the law '*should lean in favour of validating transactions undertaken by trustees in good faith if it properly can … it must also recognise that formal requirements have a purpose, and if they are not complied with, the normal consequence is that the intended transaction is of no effect.*'

Unless the trustees appeal to the Supreme Court, it seems that they may now be obliged to recover some of the excess increases paid to members since 1992. The Court of Appeal's judgment did not touch upon the High Court judge's conclusion that a six-year statutory limitation period does not apply when trustees recoup overpayments from future instalments of pension. Nor did it mention the judge's belief that the Pensions Ombudsman is not a 'competent court' for the purposes of resolving any disputes about the amounts owed by members in such cases. The Ombudsman's rejoinder is discussed elsewhere in this edition of Current Issues.

Use of new cost-transparency templates 'strongly encouraged'

The Cost Transparency Initiative has (via the Pension and Lifetime Savings Association, one of the participating organizations) published templates and guidance for asset managers and other suppliers to use to report costs and charges.[16] The standardized templates are intended to help trustees compare different suppliers' costs and obtain the best value for their investments.

Pensions minister Guy Opperman strongly encouraged adoption of the templates by pension scheme trustees and investment managers, warning that '*The Government will legislate robustly to make this happen if the industry does not resolve this on a voluntary basis at speed.*'[17]

[15] [2018] EWHC 785 (Ch). For more details of the High Court judgment, see *Current Issues* May 2018 <www.hymans.co.uk/news-and-insights/research-and-publications/publication/current-issues-may-2018>.
[16] <www.plsa.co.uk/Policy-and-Research-Investment-Cost-Transparency-Initiative>.
[17] <www.plsa.co.uk/press-centre/press-releases/article/New-tools-allow-pensions-schemes-to-deliver-greater-value-for-savers>.

HMRC newsletters May 2019

In May 2019, Her Majesty's Revenue and Customs (HMRC) published the 45th edition of its *Countdown Bulletin* series, dedicated to the abolition of salary-related contracting out.[18] It also issued *Pension Schemes Newsletter 110*.[19]

Countdown Bulletin 45

This edition of the *Bulletin* announces further extensions to key dates for HMRC's scheme financial reconciliation (SFR) exercise, in response to concerns raised by the pensions industry (it had already published revised dates for some of the steps, in the previous *Bulletin*[20]). The *Bulletin* explains what will happen in the extended period; what it means for pension scheme administrators; the extended dates of which they need to be aware; and how the extension affects HMRC's engagement in the process.

Any delay in reconciling contracted-out liabilities will inevitably set back 'GMP equalization' exercises to some extent.

Pension Schemes Newsletter 110

The *Newsletter* covers submission of annual returns for relief at source, which is relevant mainly to contract-based schemes. It also invites people to join the user panel for its *Managing Pension Schemes* service.

The most notable item for trustees of occupational pension schemes is probably the news that the Treasury is seeking views on its plans for transposition of the *Fifth Money Laundering Directive* into UK law.[21] The consultation exercise was announced on 15 April 2019 and runs until 10 June 2019.

As part of the transposition of the *Fourth Money Laundering Directive*, in 2018, trustees of certain UK occupational schemes were initially advised that they would have to sign up to a new Trusts Registration Service (TRS). HMRC subsequently revised that advice, saying that registered pensions schemes would not need to separately sign up for the TRS. The Fifth Directive will expand the requirements so that *all* UK express trusts will have to be registered, but the Government says that it is

> '*considering whether there are other registration services ... for particular trust types that could fulfil the ... registration requirement*'.

Brexit-wise, the Government is proceeding on the assumption that there will be an implementation period during which EU law will continue to apply in the UK, post-withdrawal. In any event, the Government notes that it played a significant role in drafting the *Fifth Money Laundering Directive*, and agrees with its objectives.

[18] <www.gov.uk/government/publications/countdown-bulletin-45-may-2019/countdown-bulletin-45-may-2019>.
[19] <www.gov.uk/government/publications/pensions-schemes-newsletter-110-may-2019/pension-schemes-newsletter-110-may-2019>.
[20] <www.gov.uk/government/publications/countdown-bulletin-44-march-2019/countdown-bulletin-44-march-2019>.
[21] <assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/795670/20190415_Consultation_on_the_Transposition_of_5MLD__web.pdf>.

And Finally…

AF was intrigued by a recent *Pensions Age* article (*FCA investigating 30 advisers over 'poor' advice*), which revealed that

> '[MP Nick] *Smith wrote to* [Economic Secretary to the Treasury John] *Glen to ask what action the FCA was taking against rouge advisers*'.

Well, it's an easy thing to get wrong: apply too little and one may as well not have bothered; too much and it looks like one is having a hot flush, or wears comically oversized shoes and squirty flowers in one's professional capacity…